Tax & Exchange Control
ALERT

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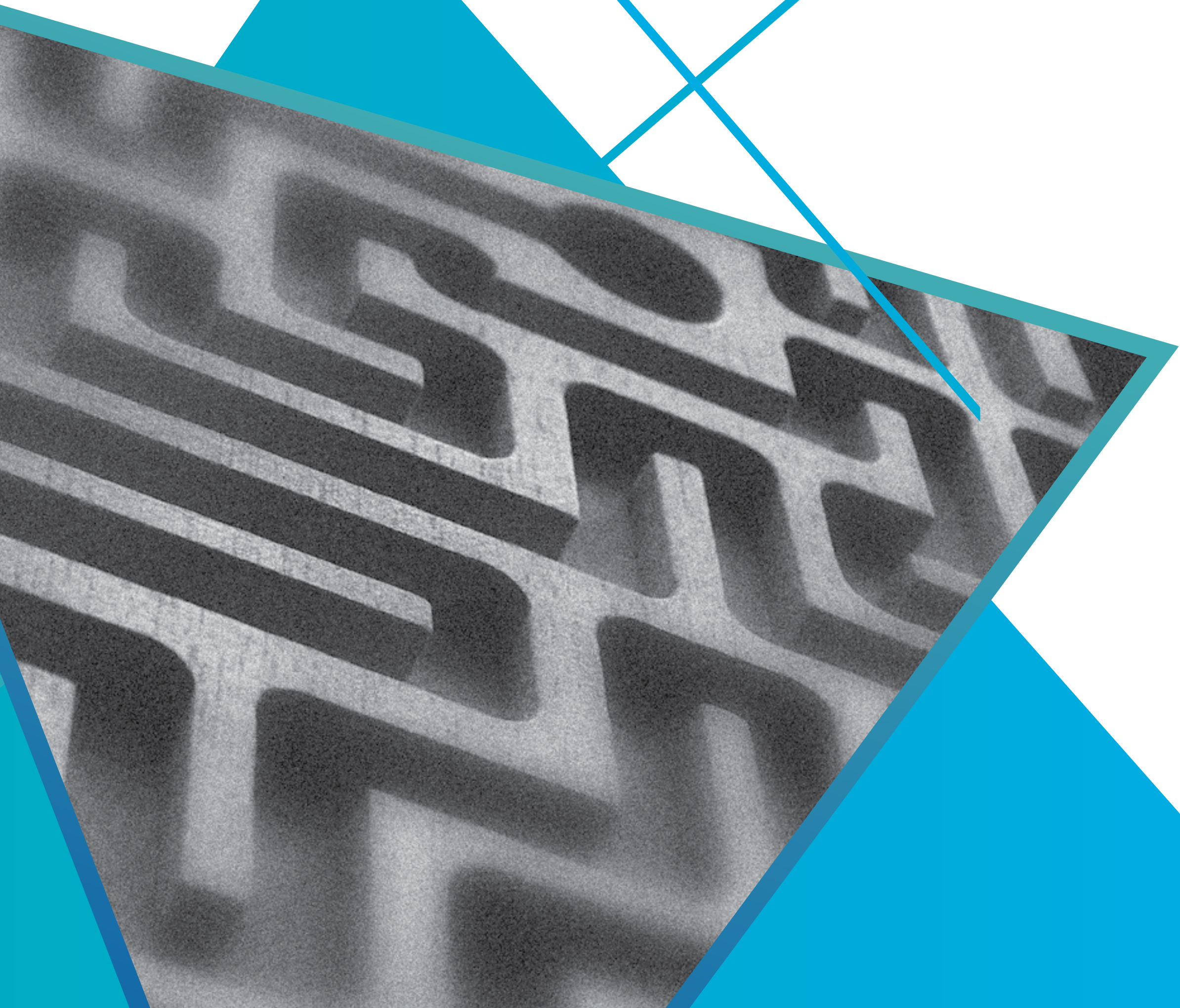
CLIFFE DEKKER HOFMEYR

INCORPORATING
KIETI LAW LLP, KENYA



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Vertical mergers are back

Section 44 of the Income Tax Act 58 of 1962 (Tax Act) is one of the lesser used of the so-called "*corporate rollover relief rules*", but is nevertheless one of the more hotly contested. Broadly, it provides for rollover relief from tax where two companies amalgamate to form one company, the other being liquidated.

Section 44(1), however, defines an "*amalgamation transaction*" as being a transaction by means of an amalgamation, conversion or merger. The circular reference in this definition does not provide much clarity on what, in fact, an amalgamation is, and there is no specific definition of amalgamation, conversion or merger in the Tax Act. This has led to much debate, as the answer to this question is necessary in determining whether the relief provided by section 44 applies to a transaction or not.

In its Comprehensive Guide to Capital Gains Tax (CGT Guide), the South Africa Revenue Service (SARS) interprets the meaning of "*merger*" (or *confusio*) as the union in the same person of the characters of creditor and debtor in respect of the same debt. SARS then provides some examples:

> "*Examples of how merger may occur include the purchase on the open market of a listed debenture by the issuer, the distribution to a beneficiary by a trust of an amount owed by the beneficiary, or the distribution in specie by a subsidiary to its holding company of a debt owed by its holding company.*"

The CGT Guide provides the following in respect of the meaning of a "*conversion*":

> "*It is submitted that a conversion involves a substantive change in the rights attaching to an asset. Some examples include the conversion of:*
>
> - *a company to a share block company and vice versa; and*
> - *a preference share to an ordinary share and vice versa (except when the rights are acquired up front).*"

Vertical mergers are back

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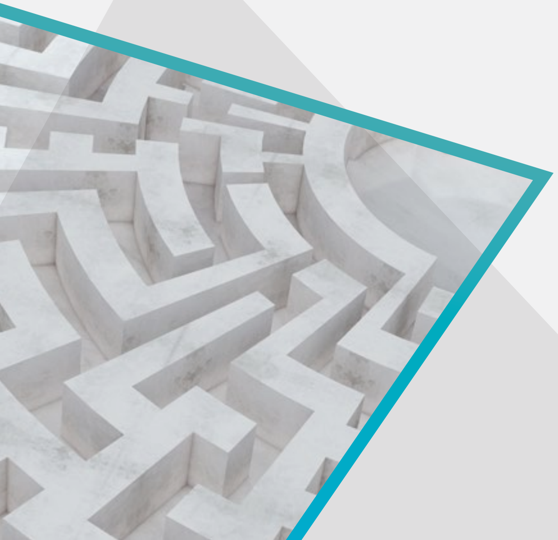
Section 1 of the Companies Act 71 of 2008 (Companies Act) defines *"amalgamation or merger"* as:

> *"a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in:*
>
> *(a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or*
>
> *(b) the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with such new company or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement …"*

With reference to the above guidance, on the one hand, a narrow interpretation of an *"amalgamation transaction"* for section 44 purposes would mean that section 44 only applies where two, independent companies, each operating its own business, pool their business assets in one of them, and therefore merge their businesses. On the other hand, a broad interpretation would mean that the business operated in one company could be transferred to another company (the latter of which may or may not necessarily conduct a business as opposed to hold some other type of important asset), the companies being amalgamated, and the business then continuing to operate from this other company.

Vertical mergers

This then leads to the question of a vertical merger. This is where one company transfers its assets to a subsidiary, receiving new shares in return and then distributing these to its shareholders before being liquidated. The effect is that the ultimate shareholders will then hold directly into the subsidiary. Although there are other provisions in the corporate rules (namely sections 46 and 47 of the Tax Act), that provide for this type of transaction, the shareholding percentage thresholds necessary for those provisions to apply mean that they are unavailable in some circumstances. If such a vertical merger can in fact fall within the ambit of section 44, this would provide relief where there was none before.



Vertical mergers are back

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Perhaps the greatest stumbling block in the context of vertical mergers is the shares held by the top company into its subsidiary. As this top company is required to dispose of all assets to its subsidiary in terms of section 44 (including these shares), it is debatable whether this would be possible as the subsidiary would not be able to hold its own shares and it would be required to cancel these. This is because of section 35(5) of the Companies Act which states that these shares become authorised but unissued shares. Further, if cancelling the shares, it is questionable whether this would be a disposal of an asset received from the top company by the subsidiary, thus triggering consequences in terms of section 44.

SARS' views on these questions were previously answered in two binding private rulings, namely Binding Private Ruling 171 and Binding Private Ruling 231 where the concept of vertical mergers within a South African tax context were approved in principle. However, at some stage SARS noted the following on these rulings: "*The principle confirmed in this ruling has been reviewed. This ruling should not be relied upon by anyone other than the applicant(s) or class members to whom it was issued.*"

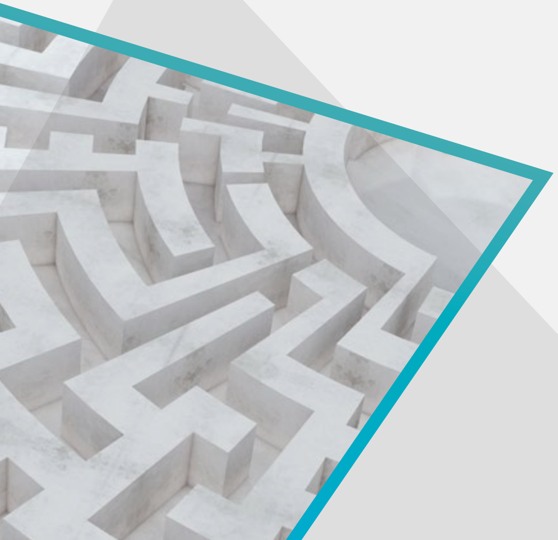
Despite the fact that vertical mergers are often the most commercial and practical means by which to resolve an internal rationalisation, given these disclaimers from SARS, the question arose whether it was still possible to implement vertical mergers within the confines of section 44.

Binding Private Ruling 397

In its recent Binding Private Ruling 397 (BPR397), SARS has again opened the door to vertical mergers using section 44 of the Tax Act. Further, it has answered many of the questions and clarified many uncertainties that were highlighted with vertical mergers.

In BPR397, the applicant and co-applicant were a company and its wholly owned subsidiary, respectively. The applicant imported pharmaceutical products, while its subsidiary (the co-applicant) held the necessary licences and marketing authorisations to import and sell these products in South Africa. The proposed transaction was therefore to use section 44 of the Tax Act in order to merge the two into a single entity housed in the subsidiary.

To do this, the applicant proposed that it dispose of all its assets and liabilities (including its shares in the co-applicant) to the co-applicant in exchange for the co-applicant issuing it new shares. These new shares would then be distributed by the applicant to its shareholders, following which the applicant would be liquidated.



Vertical mergers are back

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The co-applicant, on the other hand, would cancel its own shares which it received from the applicant, and use the other assets received from the applicant, together with its existing assets, in order to run the import and marketing business previously run by the applicant but using its (the co-applicant's) licences and authorisations. This would therefore be an amalgamation of the applicant's import and marketing business, and the co-applicant's assets necessary for this business.

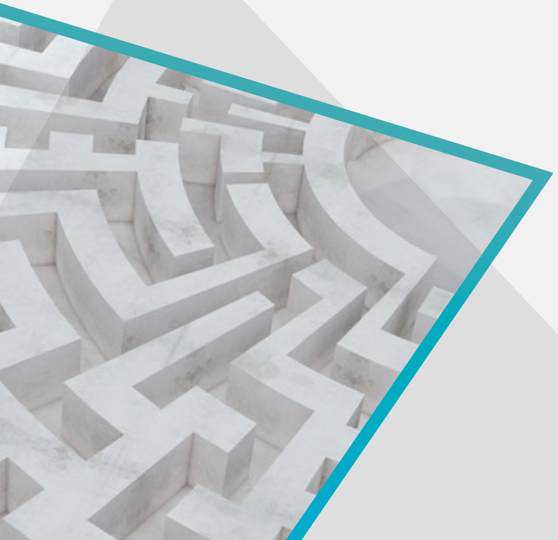
Impact of SARS' findings

The ruling by SARS, firstly, was that this would in fact qualify as an amalgamation in terms of section 44 of the Tax Act. This suggests that SARS has adopted a wider view of what constitutes an amalgamation, and confirmed that this does extend to a vertical amalgamation.

Secondly, and perhaps more importantly, however, SARS ruled that the cancellation of shares by the co-applicant would not amount to a disposal for purposes of the Eighth Schedule to the Tax Act, and therefore not trigger any adverse consequences for the co-applicant in terms of section 44. The basis for this is not set out in BPR397, but it does raise the question of whether SARS did not view the co-applicant as ever being capable of holding its own shares, and thus on cancellation not being able to be considered as having disposed of something it never held in the first place.

This question may never be answered. However, BPR397 does leave corporate taxpayers with some comfort that falling short of the thresholds set out in sections 46 and 47 of the Tax Act will not necessarily leave them without a means of winding up an intermediate company where the business housed therein can be amalgamated with that of a subsidiary. This in itself is a welcome change to the tax landscape.

Nicholas Carroll and Jerome Brink



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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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